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SUBJECT: TURKEY'S CRISIS RESPONSE: A STUDY IN INACTION

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[1](#)B. 08 ANKARA 1872

[1](#)C. 08 ANKARA 1864

Classified By: Econ Counselor Dale Eppler for reasons 1.4 b,d

[1](#)1. (C) Summary. While official data has not been released yet, all indications are that the Turkish economy contracted sharply in the fourth quarter and that unemployment continues to increase. Estimates for 2009 are bleak, with the IMF being one of the more optimistic at negative 1.5 % growth. The GOT was late in recognizing that the crisis would seriously affect Turkey and still seems unable to formulate a coherent policy response. Despite repeated public statements by ministers about industrial support and incentive programs, the GOT has yet to pass any meaningful anti-crisis package, and IMF negotiations have ground to a halt. Local experts attribute this lack of action to the GOT's lack of hands-on economic policy experience. Since the AKP came to power in 2002, Turkey's economic policy largely has been to follow prescriptions in the IMF and EU accession programs. The GOT's economic policy paralysis also owes a great deal to the stovepiped nature of decision-making, with all substantive decisions made at the PM level. The crisis is hitting Turkey mainly through the trade channel. Exports plummeted 15 % in the fourth quarter, and are expected to fall another 20 % in [1](#)2009. Left to fend for itself, the Turkish private sector is trying to develop new markets (with some limited success in Africa), but faces not only the worldwide economic slowdown and lack of financing, but also the fact that most Turkish manufactured goods are competing in the mid-level quality market, where consumers are most likely to curtail spending during a recession. End Summary.

[1](#)2. (SBU) After nearly seven years of steady, export-led growth, Turkey's economy hit a wall in late 2008. GDP growth had already slowed to 0.5 % by the third quarter and turned sharply negative in the fourth (according to IMF estimates, as much as negative 5 %). Exports held on for a few more months, but they also began a dramatic decline in late 2008, falling 15 % in the fourth quarter, led by a massive decrease in automotive (35.4 %) and textile (25.4 %) exports. Preliminary numbers for January suggest a 28 % YOY decrease in exports for the month, with a staggering 54 % YOY drop in automotive exports. The prognosis for 2009 is bleak - both imports and exports are expected to fall by at least 20 % and growth predictions are flat at best (the IMF estimates 2009 growth at negative 1.5 %, and private estimates are down to around negative 3 %, or worse if no IMF agreement is reached).

[1](#)3. (C) Economic turmoil created by the crisis is not a phenomenon unique to Turkey, but Turkey's experience to date

has been colored by the late recognition on the part of the GOT that it had a problem and its seeming inability to formulate a coherent policy response. We met with academics, government officials, and think tank analysts to try and understand why Turkey largely avoided addressing the crisis in 2008 and what the implications will be for growth and trade in 2009.

The Hidden Collapse

14. (SBU) According to Dr. Selin Boke, an economics professor at Ankara's Bilkent University, the Turkish economy had already started declining well before the financial crisis began to affect world markets, and the miniscule growth in Q3 2008 (0.5 %) was a reflection of internal problems rather than global issues. She noted that much of Turkey's growth between 2002 and 2004 was simply a recovery from the country's internal crisis in 2001 and 2002. In the period between 2004 and 2006, real growth was sustained by implementation of IMF and EU-related reforms. By 2006, however, the main IMF reforms had been largely achieved and the EU accession process lost steam. At that time, the GOT failed to come up with a substitute economic policy beyond inflation targeting (and even this policy came from the independent Central Bank rather than from the GOT proper).

15. (SBU) As a result of this policy vacuum, the economy was already heading downward by mid-2008, Boke argued. Beyond the decline in growth, Boke's claim is supported by the industrial production index, which peaked in June 2008 at 123.7 and then began a steady decline to its November 2008

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level of 109.5. Industrial capacity utilization also peaked in June at 82.4 %, falling to 64.7 % by December 2008. The unemployment rate bottomed out in May 2008 at 8.9 %, beginning its climb to 10.9 % as of November.

16. (C) Comment: Two events in 2008 helped to distract both the GOT and Turkey analysts from this decline - the AKP closure case and the initial limitation of the crisis to the financial sector. The Constitutional Court case against the ruling AKP absorbed national attention from March 2008 until the final denouement in August. Declines in FDI (down approximately 25 % in 2008 from 2007) were written off as concern over the political situation and not as symptoms of underlying regulatory disincentives to investment (such as weak IPR protections) or of global risk re-evaluations by investors. When Lehman Brothers fell just a few weeks later, the Turks legitimately claimed that their own lightly-leveraged and well-capitalized banking sector was not at risk, having been substantially reformed following the internal 2001 crisis. The initial reaction of the GOT, therefore, was either to dismiss the crisis as largely irrelevant to Turkey or to claim it as an opportunity for Turkish companies to gain market share, as PM Erdogan frequently insisted. The GOT failed to recognize that their own economy was already in decline, and also failed to appreciate the extent to which the developed world's credit problems would affect their export markets and the availability of liquidity. As a result, it did nothing. End comment.

17. (SBU) By late 2008, however, not even the most optimistic voices in the GOT could continue to ignore the facts. Eray Yucel, an analyst at the think tank TEPAV, observed that, "The Prime Minister may have been correct that the initial crisis in Turkey was a psychological problem, but it's beginning to have psychosomatic effects." As the EU and the U.S. began their slide into recession, demand for Turkish goods began to fall (exports fell 15 % in Q4). This led to a wave of factory closures and furloughs, especially in the export-dependent automotive and textile industries. The Union of Chambers and Commodity Exchanges of Turkey (TOBB) estimates that just in December 153,000 Turks lost their

jobs.

¶8. (SBU) At the same time, the foreign exchange liquidity that had been readily available to meet Turkey's USD 130 billion external financing needs became much more difficult to obtain. This was partly due to a general capital flight from emerging markets and partly to the unwinding of the lira carry trade as hedge funds and other investors withdrew funds to meet obligations elsewhere. In the third and fourth quarters, some USD 20 billion flowed out from Turkey. The GOT did take some steps in October 2008 to try and attract (or retain) capital, but without much success (see Ref C). With portfolio investment having fled, Turkey's other main channels for attracting foreign exchange - corporate borrowing and privatization - have tightened up due to a lack of interested lenders and investors. Yucel noted that the privatization program has been unofficially put on hold until market conditions improve. There has been only one successful privatization since the crisis began - the sale of Baskent Electric Distribution Corporation - and the decision on that sale was taken on September 19, early in the crisis.

Lack of Economic Policy Experience Shows

¶9. (C) Despite the (belated) recognition that the crisis had moved from finance into the real economy, the GOT has still not formulated a formal policy response. The few initiatives that have been introduced have been undertaken piecemeal and the few that have been passed have generally been small in scale. PM Erdogan recently claimed that the government has injected 10 billion lira into the economy, but the only announced stimulus measure of any size was a 350 million lira package of loans for SMEs.

¶10. (SBU) Boke attributed this lack of a coherent agenda to the government's relative inexperience at developing economic policy. When the AKP came to power in 2002, it received a gift-wrapped IMF-approved reform package that just needed implementation. The EU accession process - the other principal driver of reform in the AKP era - similarly consisted largely of harmonization with existing EU law. The

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successful realization of both programs is to the GOT's credit, but the reliance on "outsiders" for policy formulation left it with little experience in developing a reform package.

¶11. (C) The GOT's continued reliance on outside expertise can be seen in the current hope for a new deal with the IMF. Yucel noted that the GOT is "actively avoiding creative policymaking" and outsourcing it to the IMF, in the hope that if the economy continues to sour they can place the blame on the IMF's shoulders. The problem with this approach, he argued, is that the IMF's program is politically difficult for the GOT (Ref A). As such, they will eventually have to choose between an IMF package that is good for the economy but bad for them, or create their own package which might be more politically palatable but bad for the economy. He observed that reform is easy in good times, but becomes much more difficult when its negative effects are not cushioned by overall growth. Davide Lombardo, IMF Deputy Resident Representative, echoed Yucel, saying that Erdogan is slowly coming to the realization that the "easy ride is over" and that painful reforms may be necessary. Comment: The GOT's policy paralysis also owes a great deal to the stovepiped nature of decision-making and the lack of real authority at the ministerial level - any difficult decision must be made at the PM level (see Refs B and C). If Erdogan is truly coming around to the idea that reform is vital, it may ease this problem, but the need to constantly refer decisions back to him severely limits the flexibility of any GOT response. End comment.

¶12. (SBU) The GOT's lack of a policymaking capacity is not

lost on the public or the markets. Yucel stated that "The public has lost faith in the ability of the GOT to create a policy package" and suggested that the IMF package has acquired an exaggerated importance only because there is no domestic policy alternative. He noted that the EU could also help "inject" policy into the GOT, but that it is preoccupied with its own troubles and Turkey has lost interest in listening to the EU.

Impact on Trade

¶13. (SBU) Between August 2008 and February 2009, the Turkish lira depreciated approximately 35 % against the dollar. In normal times, this would be a boon to an export-oriented economy like Turkey's, as their goods become cheaper overseas. In a cruel twist of fate, however, after years of struggling against a strong high lira sustained by high interest rates, exporters find the lira has collapsed along with demand for their exports. Ziya Altunyaldiz, DDG of Exports at the Foreign Trade Undersecretariat (FTU), noted that in the long-term the lira depreciation may help Turkey's exports, but in the short-term there is nowhere to export. As a result, Turkey is being hit with the double hammer of falling exports and higher financing costs. As mentioned above, exports declined 15 % in Q4 2008 and Foreign Trade Minister Tuzmen has repeatedly predicted that both exports and imports will fall by at least another 20 % in 2009. The only bright spots, Altunyaldiz noted, are that energy prices are also falling (although even this is offset somewhat by the fact that energy is priced in dollars) and that tourism revenues have increased as Turkey becomes cheaper.

¶14. (SBU) In an attempt to find new sources of export revenue, Altunyaldiz described a plan to diversify Turkish export markets. The focus of this plan is on improving trade linkages with the Middle East and Africa, but FTU is also venturing into new territory by preparing a roadmap to increase trade with Brazil, Mexico, and Argentina through greater use of trade missions. He admitted, however, that a similar plan focused on 10 southern U.S. states had not been particularly successful, and when asked what type of products Turkey could competitively export to Latin America was unable to suggest much beyond "manufactured goods." The Africa focus does seem to be bearing some fruit, as exports to Africa have continued to increase throughout the crisis and ended 2008 up 52 % compared to 2007 (although exports to Africa still make up only 6.9 % of overall Turkish exports).

¶15. (SBU) Yucel noted that both the weaker lira and diversified markets will help the terms of trade, but that Turkey's basket of export goods makes it especially

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vulnerable to a global recession. He noted that most of the finished goods Turkey exports are aimed at the "midlevel quality" market - neither true high-end luxury goods nor cheap low-end goods. As economic conditions in the target markets decline, it is precisely consumers in that market segment that will become most price-conscious, choosing to buy at Wal-Mart instead of Sears. A cheaper lira will help position Turkish goods to be competitive vis--vis goods from the U.S. or EU, but since most emerging market currencies have also lost strength against the dollar, it will not help much against Turkey's true competitors. Given the low price elasticity for Turkish goods, Yucel was pessimistic that merely diversifying markets would be enough to turn around the export sector.

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